

ISSUE

Under the circumstances described below, is the interest income derived by a private foundation upon redemption of Series E United States savings bonds received from an estate included in the computation of gross investment income under section 4940(c)(2) of the Internal Revenue Code?

FACTS

The Series E bonds were distributed to a private foundation described in section 509(a) of the Code from the estate of the individual who purchased the bonds. Neither the individual nor the estate elected under section 454 to report the periodic increase in value of the bonds as income.

LAW AND ANALYSIS

Section 4940(a) of the Code imposes on each private foundation exempt from taxation under section 501(a) a tax equal to 2 percent of the net investment income of such foundation for the taxable year.

Section 4940(c)(1) of the Code and section 53.4940-1(c) of the Foundation Excise Tax Regulations provide that net investment income is the amount by which the sum of the gross investment income and the net capital gain exceeds the deductions allowed by section 4940(c)(3). Unless inconsistent with the provisions of section 4940, net investment income shall be determined under the principles of subtitle A.

Section 4940(c)(2) of the Code and section 53.4940-1(d)(1) of the regulations provide that the term 'gross investment income' means the gross amount of income from interest, dividends, rents, and royalties, but not including any such income to the extent included in computing the tax imposed by section 511.

Section 53.4940-1(d)(2) of the regulations provides, in part, that in the case of a distribution from an estate, such distribution shall not retain its character in the hands of the distributee for purposes of computing the tax under section 4940 of the Code.

Section 53.4940-1(d)(2) of the regulations generally allows income derived by an estate to be disregarded by a distributee private foundation for purposes of section 4940 of the Code. Thus, investment income received by and taxed to an estate is not again taxed, by virtue of section 4940, when it is received by a private foundation. This section of the regulations, however, is applicable only to the income of an estate that is subsequently distributed to a private foundation.

In this case, no part of the periodic increase in the value of the Series E bonds was reported as income by the estate. When the private foundation received the bonds from the estate, it did not receive a distribution of income of the estate. What the estate received from the decedent and ultimately distributed to the foundation was the right to receive income upon redemption of the bonds. For income tax purposes, such income would be treated as income in respect of a decedent and taxed to the one who actually received it. See Rev. Rul. 64-104, 1964-1 (Part 1) C.B. 223. Here, the entire increase in the value of the bonds will be the interest income of the private foundation when it redeems the bonds.

HOLDING

Since the increase in the value of the Series E bonds is not income of an estate that was subsequently distributed to a private foundation, section 53.4940-1(d)(2) of the regulations is inapplicable under the circumstances described above. Accordingly, the interest income derived by the private foundation upon redemption of the Series E bonds received from the estate is included in the computation of gross investment income under section 4940(c)(2) of the Code. Further, all the interest income accrued on the Series E bonds from the date of purchase by the decedent until the date of redemption by the foundation must be included in the computation of gross investment income under section 4940(c)(2).

To determine how the interest accrued on Series E bonds would be treated for purposes of computing adjusted net income under section 4942(f) of the Code, see Rev. Rul. 75-442, 1975-2 C.B. 448.